

TESTIMONY OF DEAN SCHULTZ, PRESIDENT  
FEDERAL HOME LOAN BANK OF SAN FRANCISCO

Before the Federal Housing Finance Board  
April 11, 2002

Chairman Korsmo and Members of the Federal Housing Finance Board, I am pleased to have the opportunity to testify before you today on the topic of Federal Home Loan Bank capital plans, particularly the structure that the San Francisco Bank believes is most consistent with the statute and regulations, the Banks' cooperative structure, and the Banks' ability to provide liquidity for their members in a safe and sound manner. We previously provided the Finance Board with comments on this topic by letter dated February 22, 2002. A copy of that letter is attached to this testimony and incorporated by reference.

**Legal Context**

Let me begin by describing our understanding of the legal context in which our Plan was designed. Section 6(c)(1)(C) of the Federal Home Loan Bank Act ("Bank Act") requires each Bank's capital plan to set the member stock purchase requirements

"... at a level that is sufficient for the bank to meet the minimum capital requirements established by the Finance Board ...."

Similarly, Section 931.1(a) of the Finance Board's regulations provides, in relevant part:

"A Bank shall require ***each member*** to maintain a minimum investment in the capital stock of the Bank, both as a condition to becoming and remaining a member of the Bank and as a condition to transacting business with the Bank or obtaining advances and other services from the Bank. ***The amount of the required minimum investment ... shall be sufficient to ensure that the Bank remains in compliance with its minimum capital requirements. A Bank shall require each member to maintain its minimum investment for as long as the institution remains a member of the Bank and for as long as the member engages in any activity with the Bank against which the Bank is required to maintain capital.***"

We read these provisions of the statute and the regulation to mean that if one adds up the membership and activity stock purchase requirements of all of a Bank's members, the resulting amount of capital must equal or exceed the Bank's total capital requirement. The last sentence of 931.1(a) makes clear that to be consistent with the statute and regulations, this would mean that each Bank's capital plan must require ***each member*** to purchase and maintain capital stock in the Bank, both as a condition to becoming and remaining a member and as a condition to transacting business with the Bank. In order to ensure that the amount of this stock purchase requirement is sufficient

for a Bank to remain in compliance with its own regulatory capital requirements, the Bank's capital plan must require each member to provide the capital necessary to fund its own activity with the Bank. If the Finance Board did not intend for *each member* to be responsible for *its share* of the Bank's total capital requirement, as opposed to using the excess capital of another member to count against its share, there would be no point in linking the maintenance requirement of *each member* to its term of membership or to the term of any activity with the Bank against which the Bank is required to maintain capital.

Finally, the statute and regulations require a Bank to redeem a member's stock at the end of the applicable redemption period, unless following the redemption the Bank would fail to satisfy its regulatory capital requirements or the member would fail to maintain its minimum stock purchase requirement.<sup>1</sup>

### **Background on San Francisco Bank's Capital Structure**

Within this legal context, let me discuss the thinking that went into the development of the San Francisco Bank's Capital Plan. In designing the new capital structure, we wanted a Plan that would:

- Comply with the statute and regulations;
- Effectively support the Bank's business model and its public policy mission;
- Allow the Bank's capital to expand and contract with member activity;
- Provide a consistent and predictable stock purchase requirement for members;
- Preserve the Bank's cooperative nature; and
- Provide for safety and soundness.

As a result, the Bank's Capital Plan is designed to:

- Treat members equally;
- Enable the Bank to meet its regulatory capital requirements under a wide range of balance sheet structures; and
- Be easy to understand and manage.

The Plan provides for stock purchase requirements that require members to fully capitalize their transactions with the Bank, both advances and loan sales (including the purchase of stock to capitalize the liquidity associated with these member transactions). We believe this approach permits the Bank's capital to expand and contract with member activity, thereby minimizing volatility in the Bank's leverage capital ratio. This is obviously particularly true in the case of expanding member activity. Consequently, the possibility that member stock purchase requirements will have to be changed from time to time is minimized. This approach also best serves the Bank's cooperative structure. It promotes a consistent and predictable stock purchase requirement for members, because a particular member's requirement is not subject to change based on the activity of other members. Equal treatment of all borrowing members is a key component of the Bank's cooperative structure.

### **Problems Inherent in Other Approaches**

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<sup>1</sup> See Sections 6(a)(4)(A), 6(c)(1)(A), and 6(f) of the Bank Act and Section 931.7 of the Finance Board's regulations.

We looked at the incorporation of excess capital into our Capital Plan and at activity requirements that provided less capital than needed for the asset placed on the Bank's books. If one could get past the legal issues involved, we still saw substantial problems with that approach. Capital Plans that establish member stock purchase requirements that are lower than the Bank's capital requirements for a particular member activity (advances or acquired mortgage assets), cannot provide assurance that a Bank will be able easily to expand and contract with such activity. If a plan relies on excess capital to fund member activity (advances or mortgages), and the member supplying the excess capital wants it back and provides the five-year redemption notice, then the Bank must do one of four things at the end of the redemption period. First, the Bank could sell the assets, which may or may not be a good idea at the time based on the then-current market value of the assets. Second, it could increase member stock purchase requirements, and make all of its members provide the needed capital. This seems inequitable in that all members would be forced to capitalize the activity of a select group of other members. Third, if the Finance Board permits it to do so, the Bank could offer voluntary purchases of capital to members. It is foreseeable that this solution may not always be available. Fourth, the Bank could refuse to redeem the stock because it wouldn't meet its capital requirements if the redemption were to take place. This last solution seems particularly unfair, because the Bank would have engineered itself to a position that compels it to deny a member's redemption request, in order to have the capital available to fund another member's activity.

Fairness seems to be an issue in any structure wherein members do not capitalize their own activity. For example, plans that rely on large amounts of excess stock may not provide equitable treatment for all member borrowers. Subjecting different members to different stock purchase requirements for the same activity, not on the basis of credit or other relevant criteria, but rather on the amount of excess stockholdings by other members, does not appear to us to best serve the Banks' cooperative structure (nor does it appear to be consistent with Section 7(j) of the Bank Act, which requires equitable treatment for all member borrowers). A redemption provision that prohibits a member from redeeming excess capital stock except upon withdrawal from membership is not consistent with the Finance Board's interpretation of the Bank Act. In its review of the Banks' capital plans, the Finance Board staff has stated that unless redemption would cause the Bank to fail to satisfy its regulatory capital requirements or the member to fail to maintain its minimum stock purchase requirement, then the Bank *must* redeem excess stock at the end of the redemption period.

In order to address some of the problems inherent in these other structures, the Finance Board has proposed that each Bank's capital plan contain a capital sufficiency test provision. The purpose of this provision is to ensure that a Bank does not place undue reliance on excess stock (as opposed to required stock) in order to maintain its own minimum capital requirements. Therefore, following a two-year transition period, the capital sufficiency provision requires that the *stock purchase requirements for members* (not simply the total amount of stock in the Bank) must be sufficient to meet the test set out in the referenced provision.

## **Governance Issues**

Pursuant to Section 6(b)(1)(C) of the Bank Act, the imposition of capital plan requirements, such as the suggested capital sufficiency provision, is well within the authority of the Finance Board.<sup>2</sup> While certain governance issues formerly within the Finance Board's purview are now within the purview of the Banks, it is clear that the Banks' capital plans must comply with rules established by the Finance Board.

## **Conclusion**

We believe that the most effective capital structure for a Federal Home Loan Bank requires each member to purchase Bank stock in an amount sufficient to capitalize its own activity with the Bank. Further, in accordance with the Banks' cooperative structure (and section 7(j) of the Bank Act), we believe that each Bank's stock purchase requirements should be consistent from member to member.

I appreciate the opportunity to present this explanation of the San Francisco Bank's Capital Plan.

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<sup>2</sup> Section 6(b)(1)(C) of the Bank Act requires that each Bank's capital plan must comply with rules established by the Finance Board